Q2 2019 | Putnam High Yield Fund Q&A

High yield gains amid supportive risk sentiment

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Following heavy selling pressure in 2018's fourth quarter, high-yield bonds posted their best start to a calendar year in a decade during the first four months of 2019.

The fund benefited from security selection in financials and health care. On the downside, underweight allocations to transportation and food & beverages dampened relative performance.

We have a positive outlook for market fundamentals but think valuations are less attractive following strong performance year to date.

Not FDIC insured | May lose value | No bank guarantee

What was the market environment like for high-yield bonds?

High-yield bonds rose 2.60% for the second quarter, as measured by the JPMorgan Developed High Yield Index, outpacing high-yield bank loans but trailing the broad investment-grade fixed-income market.

The asset class began the year strongly after a volatile final quarter of 2018. With investors shedding conservatism and embracing risk assets, the index rose 8.9% for the year-to-date period through April, its best opening four-month stretch since 2009. Investor sentiment improved markedly following comments from Federal Reserve Chair Jerome Powell that mild inflation would give the central bank greater flexibility to set policy in 2019. Market participants also welcomed Powell's announcement that the Fed was not on a "pre-set" path to push its benchmark rate higher, after hiking rates every quarter in 2018. Better-than-expected corporate earnings, a rebound in oil prices, and progress in U.S.–China trade talks were additional factors fueling the recovery.

The tide turned somewhat in May, as high yield registered negative performance amid heightened trade tensions and deteriorating global growth data. Declining oil prices late in the month also weighed on the asset class.

High-yield credit rebounded in June alongside U.S. stocks, as sentiment benefited from a dovish Fed and hopes that the United States and China would restart trade negotiations. At the Fed's policy meeting in June, a greater-than-expected number of Fed governors expressed support for easing monetary policy this year. At the end of June, President Trump and his Chinese counterpart, Xi Jinping, met during the G-20 summit in Japan and agreed to resume formal trade talks. Oil prices bounced back during the second half of June on expectations that the Organization of Petroleum Exporting Countries [OPEC] was likely to extend its output cuts into next year.

Against this backdrop, the fund's benchmark was ahead by nearly 10% for the year to date through June.

Within the JPMorgan index, all but one cohort posted a gain, with energy registering slightly negative performance. Retail, cable & satellite, gaming, and housing were the best performers among major industry groups, each advancing about 4%. Transportation, a relatively small index component, rose about 5%. In addition to energy, cohorts lagging the index included health care [+1%], metals & mining [+2%], and technology [+2%]. From a credit-rating perspective, higher-quality BB-rated bonds produced the best results, gaining about 3%.

The fund slightly outpaced its benchmark for the quarter. What factors had the biggest influence on relative performance?

On the plus side, we benefited from security selection in financials and health care, along with an overweight allocation to cable & satellite. Conversely, underweight exposure to transportation and food & beverages, as well as negative selection in energy, hampered performance versus the benchmark.

What is your outlook for the high-yield market over the coming months?

We evaluate the high-yield market through three lenses: fundamentals, valuation, and "technicals," or the balance of supply and demand. As of June 30, we thought the fundamental environment and the technical backdrop were generally positive, but we had a more neutral outlook toward valuation.

Despite global trade uncertainty, we think the fundamental backdrop for high yield remains supportive, aided by favorable corporate earnings, a strong labor market, and solid U.S. economic growth. Strong exports and inventory investment helped U.S. gross domestic product grow at a 3.1% annual rate in the first quarter of 2019. That marked a significant improvement from the last three months of 2018, when the economy grew at a 2.2% rate.

After-tax corporate profits, without inventory valuation and capital consumption adjustments, fell 0.2% in the first quarter of 2019 from 2018's fourth quarter — the second straight quarter of declining profit growth. In our view, weaker earnings growth was attributable to soft global demand, trade uncertainty, and a strong dollar, which makes U.S. exports more expensive.

Looking at defaults, when distressed exchanges are included in calculating the U.S. high-yield default rate, the figure was 1.55% as of June 30. Defaults declined materially during the past 12 months and are now at a level last seen in 2014. We think defaults are likely to remain low for an extended period, given the relative financial health of high-yield issuers and the fact that many have refinanced and extended bond maturities into the future.

The market's technical backdrop improved during 2019, aided by a combination of modest net new issuance and a return to strong fund inflows. Specifically, net new volume [net of refinancing-related new issuance] was $46.6 billion year to date, only slightly greater than the net volume in the same period in 2018. Meanwhile, flows into retail and exchange-traded funds totaled $12 billion, compared with outflows of -$24.5 billion during the same period last year.

Turning to valuation, in June, high-yield spreads partially retraced the widening that occurred during May, and remain tighter than where they began the year. Overall, we think spreads look fairly valued. From an income perspective, the average yield of the fund's benchmark was 6.46% as of June 30. [Yield spreads are the yield advantage high-yield corporate bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as spreads tighten and fall as spreads widen.]

How have you positioned the fund in light of this outlook?

During the quarter, we continued to reduce risk in the portfolio by decreasing our exposure to CCC-rated credits, while maintaining an overweight allocation to BB-rated bonds.

At the industry level, we favored gaming, lodging & leisure and financials. Conversely, we had lower-than-benchmark exposure to food & beverages, consumer products, transportation, services, automotive, and health care.

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 6/30/19

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	2.74%	2.60%
1 year	6.67	7.51
3 years	6.65	7.80
5 years	3.87	4.78
10 years	8.16	9.66
Life of fund	7.42	—
Total expense ratio: 0.78%		

Returns for periods of less than one year are not annualized.

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance assumes reinvestment of distributions and does not account for taxes. For the most recent month-end performance, please visit putnam.com. Class Y shares before their inception are derived from the historical performance of class A shares (inception 3/25/86), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, this fund may have had expense limitations, without which returns would have been lower. Class Y shares are generally only available for corporate and institutional clients and have no initial sales charge.

The JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed-income securities issued in developed countries. You cannot invest directly in an index.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers as of June 30, 2019, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before investing: The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political or financial market conditions, investor sentiment and market perceptions, government actions, geopolitical events or changes, and factors related to a specific issuer, geography, industry or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings.

Lower-rated bonds may offer higher yields in return for more risk. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds (a significant part of the fund's investments). Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Unlike bonds, funds that invest in bonds have fees and expenses. You can lose money by investing in the fund.

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